



Business Consulting Services

USAID Financial Sector Training Module 6: Pension Reform



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20 December 2002

Agenda

- Why pension reform?
- What do you need for pension reform?
- Examples of pension reform
- Group exercise
- Summary

Agenda

❖ Why pension reform?

What do you need for pension reform?

Examples of pension reform

Group exercise

Summary

What are pensions?

Definition of pensions

- Income received in retirement (or disability) by former workers
- Provided by the state, e.g., Social Security or private sources

Definition of private pensions

- Savings vehicles that provide a **replacement income** in retirement, often to supplement a state income
- Such plans typically are not run by the State, but are approved by the State, and often receive tax advantages

Why pension reform?

- Existing social security system inadequate
 - Provide too little income
 - Does not reach enough people
- No existing social security or retirement system
 - Traditional ways may not be viable, e.g., family support
 - Financial market development ready to support long-term savings
- Existing system in crisis
 - Fiscal deficits are unsustainable
 - Demographic shift requires changes
 - Other systemic problems, e.g., evasion, fraud



ABCs of pension reform

ABCs

- Adequate income for retirees
- Budget
- Capacity

Policy Considerations

- Age of retirement
- Benefit at retirement
- Contribution rate
- Demographics

Pension reform goals

- Pension system that provides an adequate income to retirees
- Fiscally sound and sustainable pension system
- Efficient, cost-effective and reliable
- Link contributions and benefits to minimize labor market distortions



The challenges

- Benefit arrears
- Shadow or 'gray' economy
- Poor administration
- Poor compliance
- Low retirement age
- Declining birth rates
- Benefits not tied to contributions

Types of pension reforms

- Parametric
 - Change the rules for retirement age, eligibility, benefits, contributions
 - Combat evasion to increase participation
- Notional Defined Contribution (NDC)
 - Link benefits to contributions
 - Minimize labor market distortions with incentive to join formal sector
- Systemic
 - Create funded pension plans
 - Generate long-term savings
 - Help stimulate capital markets development

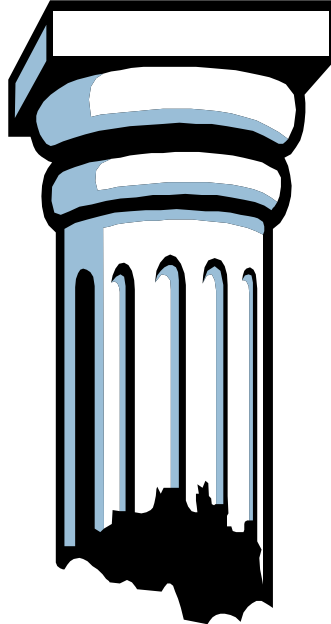
Source: Pension Reform and Capital Market Development: “Feasibility” and “Impact” Preconditions, World Bank 1999, Dmitri Vittas.

Multi-Pillar Pension System



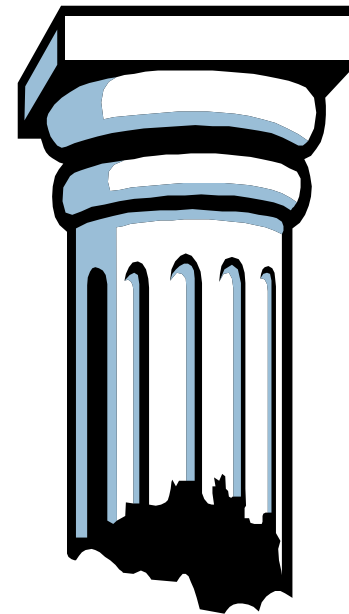
1st Pillar

- PAYG
- Government managed
- Defined benefit



2nd Pillar

- Mandatory
- Privately managed
- Defined contribution



3rd Pillar

- Voluntary
- Privately managed
- Employer-sponsored
- Individual

Second pillar considerations

- Contributions:
 - Rate
 - Who contributes
- Collection of contributions: centralized vs. decentralized
- Guarantees:
 - Minimum pension
 - Minimum return
 - Market risk
- Management: public involvement vs. private sector
- Oversight: new supervisory agency or existing regulator?
- Technology challenges

Agenda

Why pension reform?

❖ **What do you need for pension reform?**

Examples of pension reform

Group exercise

Summary

What do you need?

Pension reform preconditions

Pension reform is not a leading edge reform. Pension reform builds on other financial and economic development initiatives, providing long-term capital for sustainable growth.

- Stable banking system
- Adequate legal structure
- Capital markets development
- Effective financial sector regulation
- Effective corporate governance
- Economic activity and others

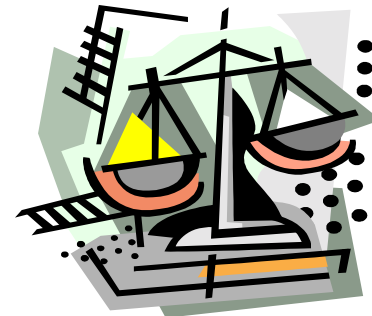
Pension reform preconditions

Stable banking system

- Provides liquidity
- Payments system
 - Contributions
 - Benefits
- Serves as conduit between lenders and borrowers
- Lowers transaction costs
- Promotes confidence in financial system

Adequate legal structure

- Allows recourse
- Protects property rights
- Enforces binding contracts
- Protects consumers and investors
- Promotes confidence in the economy



Pension reform preconditions

Capital market development

- Investment products
 - Debt
 - Equity
- Market intermediaries
 - Stock markets
 - Bond markets
 - Brokers and dealers
- Service providers
 - Custodians
 - Clearing and settlement
 - Depositories

Financial sector regulation

- Sound laws and regulations for banking, capital markets, and insurance
- Enforcement and compliance
- Institutional development of regulatory capacity
- Promotes confidence in financial system

Pension reform preconditions

Effective corporate governance

- Adequate protection of investor interests
- Professional management
- Accounting standards
- Recent US scandals show why these are important
 - Enron
 - WorldCom
 - Adelphia

Economic activity & others

- Macroeconomic 'stability'
- Sufficient level of economic activity – cash vs. credit
- Adequate disclosure of financial information
- 'Free' press with 'watchdog' journalists
- Consumer awareness and education

Agenda

Why pension reform?

What do you need for pension reform?

Examples of pension reform

Group exercise

Summary

Pension reform examples from Central and Eastern Europe

Multi-pillar pension reforms with 2nd pillar

- Hungary 1998
- Kazakhstan 1999
- Poland 1999
- Bulgaria 2001
- Croatia 2002
- Macedonia 2004

Pension reform challenges in Central and Eastern Europe

- Existing pension system crisis
- Administrative issues
 - No computerized records
 - Benefits paid in cash through postal system
 - Antiquated, manual accounting systems
 - Contribution collection
- Market development
 - Liquidity
 - Investment alternatives
 - Accounting valuations
- Legal and regulatory issues
 - ‘Turf’ battles between regulators
 - Weak enforcement and compliance
 - Inflexible laws
- Public education
 - Promote awareness
 - Increase participation
- Shadow economy
 - Participation
 - Evasion
- Infrastructure
- Foreign participation

CEE response

Pension reform characteristics

- Government-based pension system plus complementary market-based pension system
- Compulsory fully-funded pension schemes added
- Trade unions as active participants
- Investment restrictions

Major changes

- Raised retirement age
- Changed benefits
 - Benefits formula
 - Indexation provisions
- Established private pension fund supervisory authorities
- Continued capital markets development

Country examples: 2nd pillar participation

Hungary

- Compulsory for new entrants to the labor force
- Voluntary for all others

Poland

- Compulsory for new entrants to labor force and all under 30 years
- Voluntary for workers age 30-50 years

Bulgaria

- Compulsory for new and younger workers

Croatia

- Compulsory for new workers and those under age 40
- Voluntary for workers age 40-50 years

How has USAID helped?

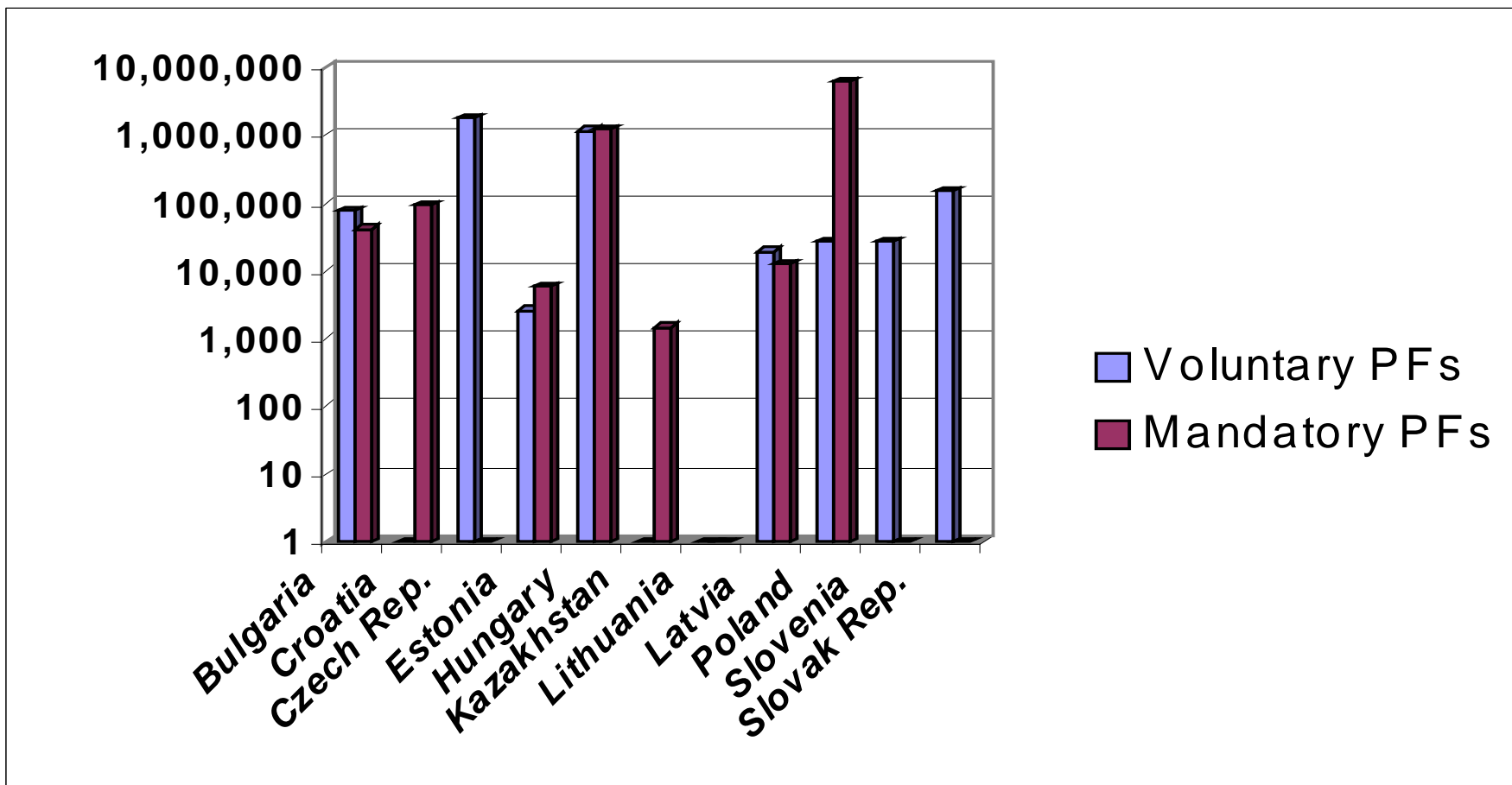
- Legal and regulatory framework
- Actuarial analysis
- Public education
- Information systems
- Compliance and enforcement
- Education
- Technical knowledge transfer



Lessons learned from pension reform

- One size does **not** fit all
 - Broad coverage requires a mix of all three pillars
 - Different types of reform alternatives: defined benefit, defined contribution, notional defined contribution
 - Funded vs. unfunded
- Costs are high
 - Transition costs
 - Infrastructure investments
 - Public education

CEE Pension fund assets



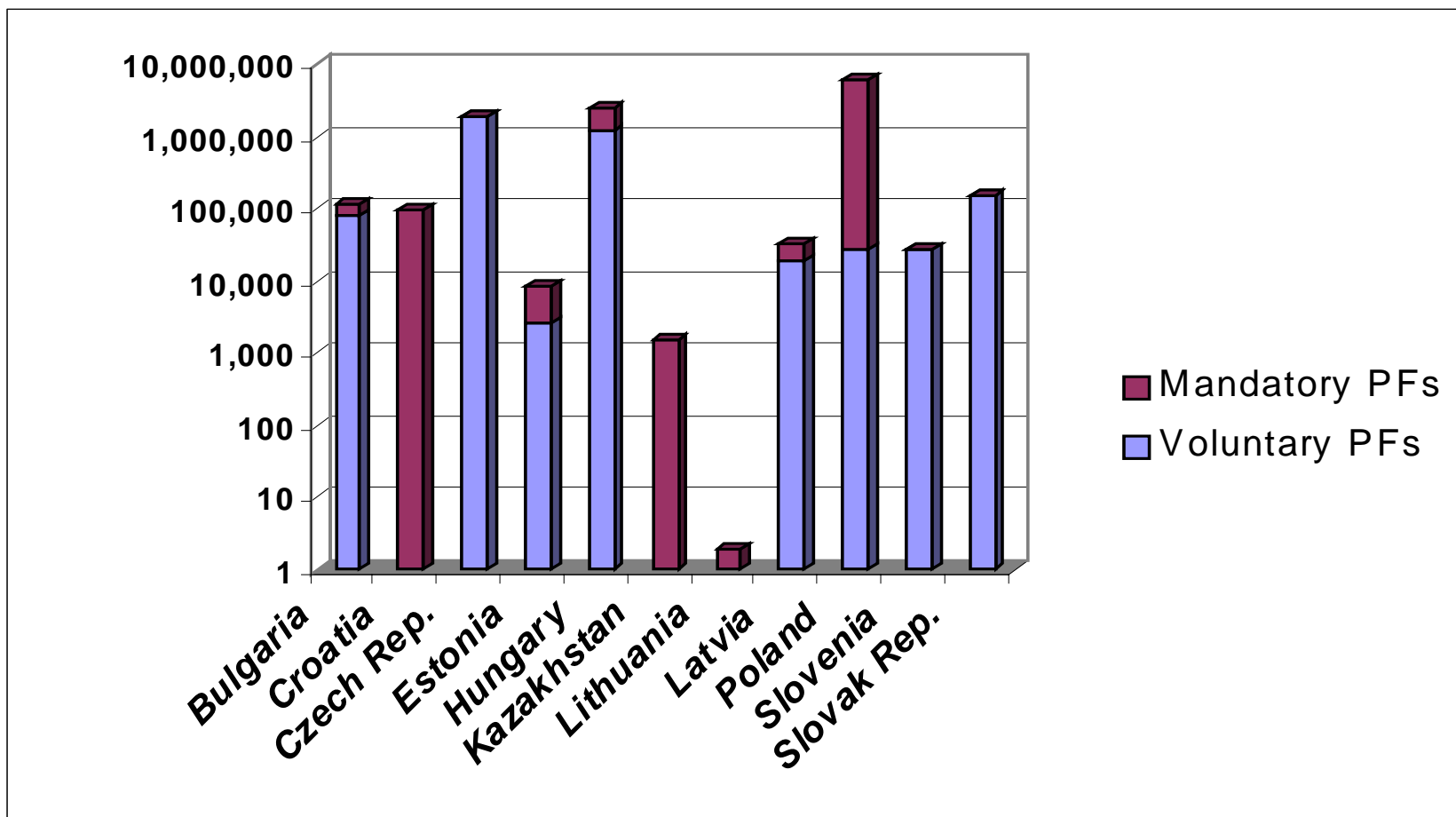
Source: EWMI. November 2002. Special thanks to Tibor Parniczky,

CEE Pension fund statistics

	Start of		Contribution to	
	Voluntary PFs	Mandatory PFs		
Bulgaria	1996	2000/2002*	2%, 7% or 12%	*
Croatia	2002	2002	5%	
Czech Rep.	1994	N/A	-	
Estonia	1998	7/1/2002	4%	
Hungary	1994	1998	6%	**
Kazakhstan	1998	1998		
Lithuania	2000	N/A	-	
Latvia	7/1/1998	7/1/2001	2%	
Poland	1999	1999	7.30%	**
Slovenia	2000	N/A	-	
Slovak Rep.	1996	N/A	-	
* depending on status of occupation				
** capped as multiple of the average earnings				

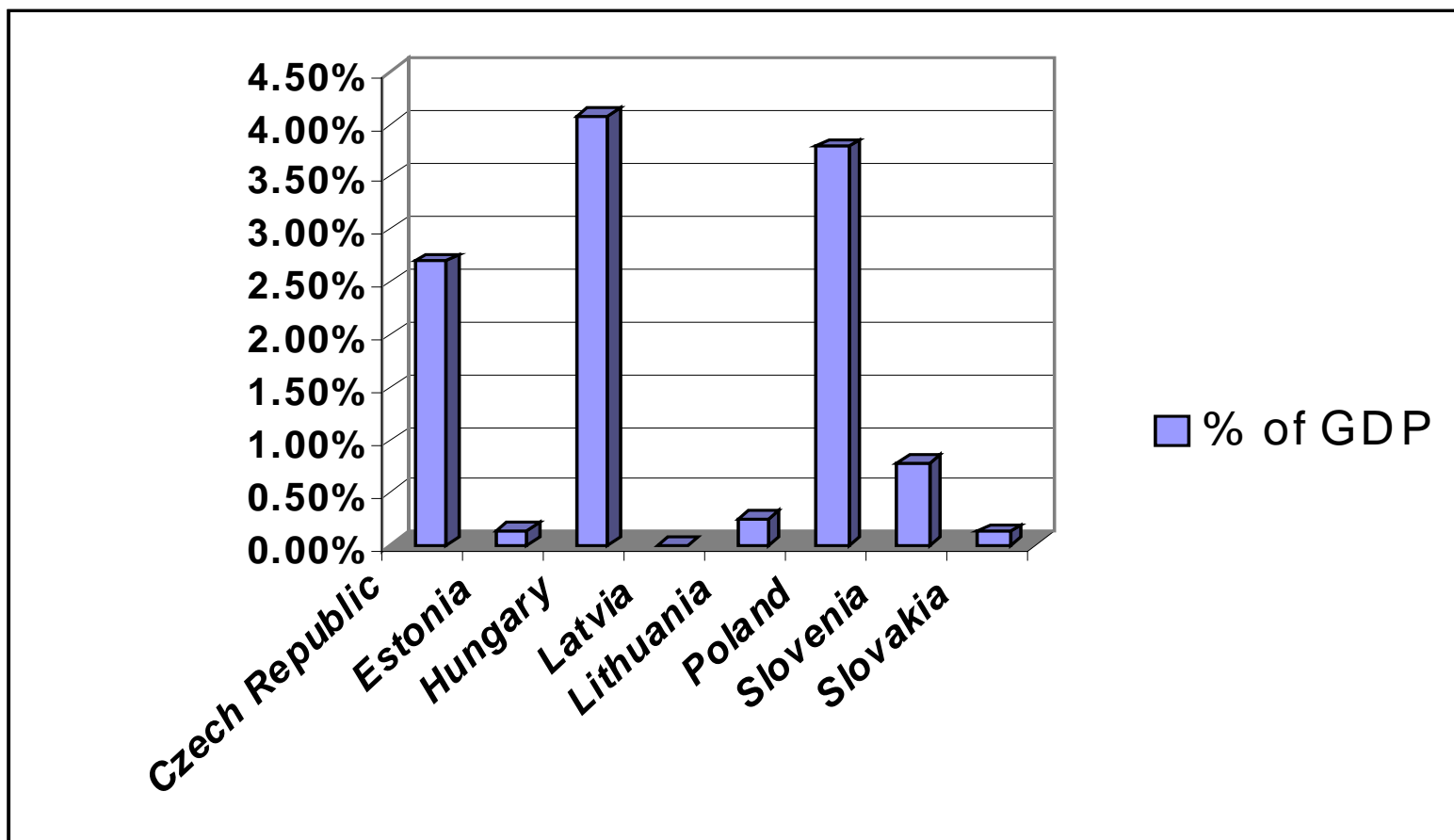
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CEE total pension fund assets



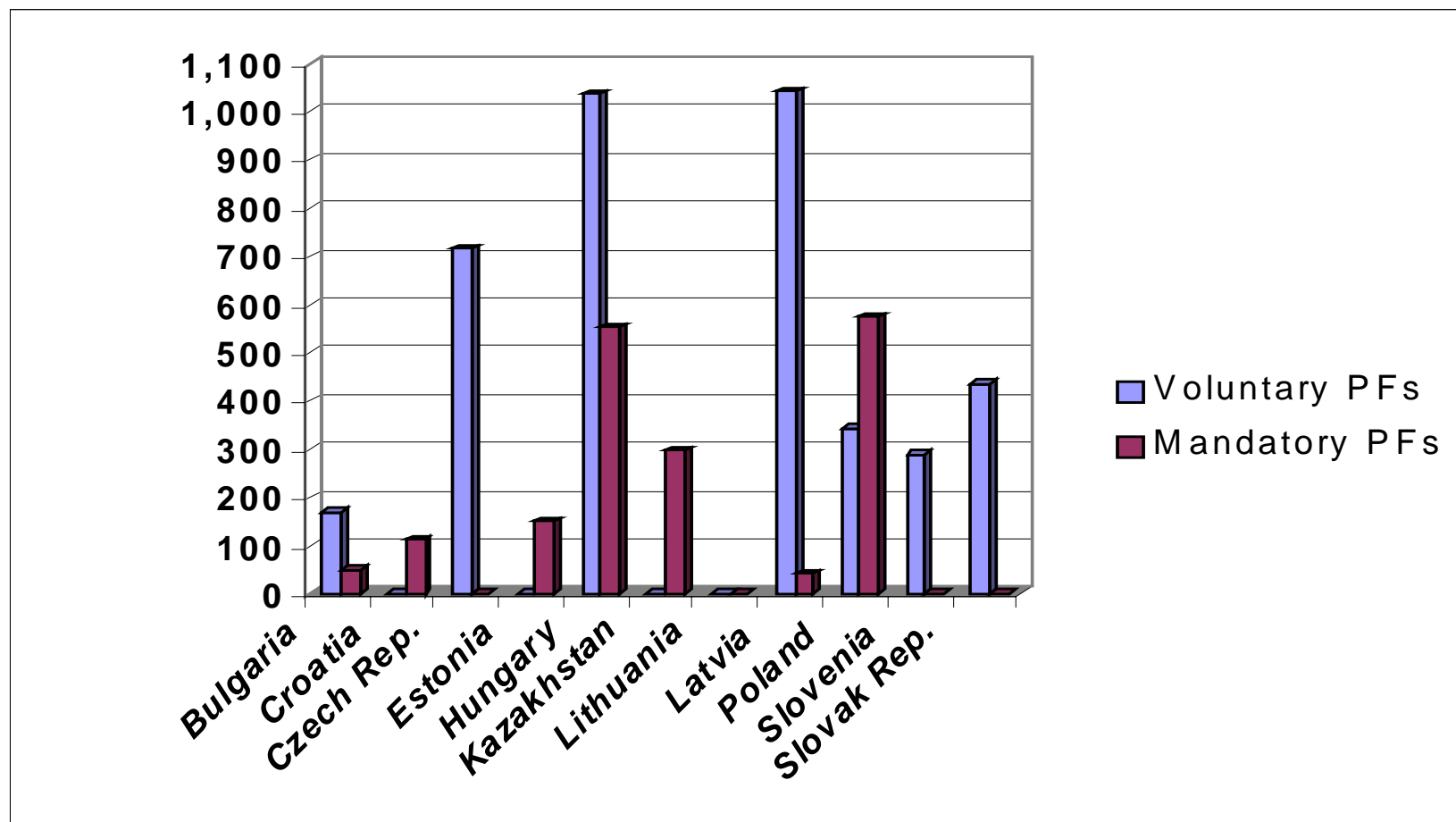
Source: EWM. November 2002. Special thanks to Tibor Parniczky,

CEE Pension fund assets as % of GDP



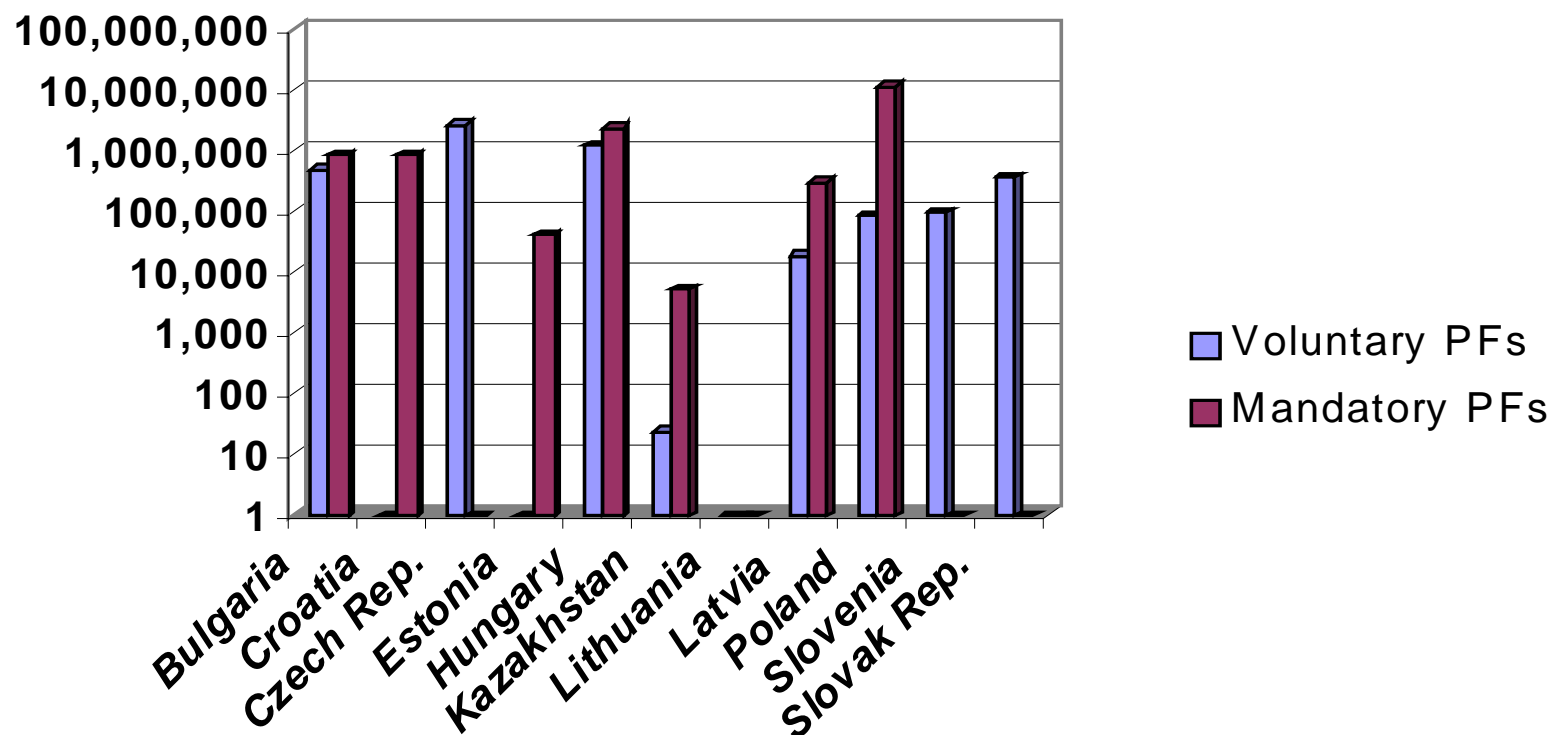
Source: EWMI. November 2002. Special thanks to Tibor Parniczky,

CEE average individual pension account



Source: EWMI. November 2002. Special thanks to Tibor Parniczky,

CEE pension fund participation



Source: EWMI. November 2002. Special thanks to Tibor Parniczky,

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Why pension reform?

What do you need for pension reform?

Examples of pension reform

❖ **Group exercise**

Summary

Group exercise

- Choose a country
- Assess the conditions for pension reform in that country
 - Formal vs. informal sector
 - Existing pension system?
 - Financial sector development
 - Other
- Design a pension reform for your country
- Recommend activities which USAID can undertake to support pension reform in the chosen country



Group exercise: food for thought

Pension reform considerations

- Voluntary vs. mandatory participation
- Informal sector participation
- Retirement age
- Contributions
- Regulatory agency
- Investment guidelines
- Guarantees
- Financial sector development
- Public awareness
- Linkage to privatization

USAID program considerations

- What is the level of public awareness and understanding of pension reform?
- Does the legal and regulatory framework support pension reform? Financial, general.
- Is the financial infrastructure in place to support pension reform?
- How is the institutional capacity to support pension reform?
- What is the state of play of corporate governance?
- How can USAID help increase the chances for a successful pension reform



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Thank you!



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